Department of Finance Ministère des Finances

INFORMATION

OTTAWA, CANADA K1A 0G5 (613) 992-1573

Immediate release

Ottawa, November 21, 1991
91-121

Statement by the Honourable Don Mazankowski
Minister of Finance
for an appearance at the
House of Commons Standing Committee on Finance

November 21, 1991

Canada

Introduction

I welcome the opportunity to appear before the Commons Finance Committee today.

The Canadian economy is emerging from what has been a difficult and, for many, a painful economic period. While recovery has begun, it is still not as broadly based as we would like.

For many Canadians, difficulties persist. Confidence is still relatively weak, and the high level of unemployment is a concern to all of us. There is also uncertainty about the prospects for our major trading partners and the implications this may have for Canada. I know, too, there are concerns that the deficit may be off-track.

I want to use this opportunity today to address some of these concerns by providing an update on Canada's economic and fiscal situation and our prospects for the near future.

Plan for Economic Recovery

At the outset, I want to put current developments into perspective. They should be understood in the context of the factors that pushed the economies of Canada, the United States, the U.K. and other countries into recession. They should also be seen in terms of the actions the government has taken not only to generate recovery but to put the Canadian economy on the path to sustainable, long-term growth.

The recession, in Canada as in other countries, was the result of rapidly growing inflationary pressures during the late 1980s. Inflation and inflation expectations surged,

wage demands in many cases rose faster than inflation, and productivity sagged. Demand growth was fuelled more by credit than by sound economic fundamentals. And large government deficits continued to distort credit markets and absorb savings that could have, and should have, been used for private sector investment. At the same time, the negative impact of these developments was being reinforced by declining levels of economic confidence.

The February 1991 budget set out a strategy to deal with these problems, and to provide the basis for renewed confidence, not just in the near term but on a sustained basis. Durable growth can't be produced by quick, simplistic solutions. That is why the government's Plan for Economic Recovery is built upon a series of medium-term actions designed to address fundamental Canadian economic problems. The goal of the Plan is ambitious -- to create the essential conditions for durable recovery that will bring lasting growth and productive, rewarding jobs for Canadians. Confidence that this goal will be achieved requires a credible policy framework.

In the budget, we said that lower interest rates over the long term are the key to sustainable economic recovery. But to get interest rates down, and more importantly to keep them down, it is essential to reduce, and ultimately eliminate, inflation and inflation expectations. That is not an easy task: Canada went from having one of the industrial world's lowest inflation levels in the 1950s and 1960s to one of the higher inflation levels in the 1970s and early 1980s.

There are several important ways that the Plan for Economic Recovery is working to reduce inflation, and hence produce durably lower interest rates.

- First, last January, the year-over-year consumer price index (CPI) inflation rate was 6.8 per cent. We established firm, realistic inflation targets aimed at bringing inflation down to 3 per cent by the end of 1992 and to

2 per cent by mid-decade. These targets are sending a clear message to Canadians that the government and the Bank of Canada are committed to price stability. The value of these targets is that they help to reduce inflationary expectations and thus speed the adjustment to price stability.

- Second, we knew government had to take the lead in restraining government wages and salaries, to assist the process of inflation reduction. Therefore, at the federal level, the wages and salaries of parliamentarians, public servants and those who hold order-in-council appointments have been frozen this year, and will be limited to increases of 3 per cent in each of the next two years. Eight of the provincial governments have also put wage restraint programs in place.

- Third, we knew we had to maintain our commitment, through concrete actions, to put federal government finances firmly on course to a balanced budget. Price stability requires that government deficits not be a source of inflationary expectations, and an overbearing competitor for scarce funds in capital markets. We reaffirmed our commitment to deficit targets of $30.5 billion in 1990-91 and 1991-92, notwithstanding the pressures from the recession; we remain committed to a deficit target under $25 billion in 1992-93 and to reducing financial requirements to zero by 1994-95.

Step by step the Plan for Economic Recovery is realizing its objectives. We are meeting the inflation and fiscal targets. Interest rates are falling. And, as we expected, a modest recovery has begun. But to strengthen confidence, and firmly put in place the conditions for sustainable economic recovery, we must maintain our commitment to pursuing the key medium-term elements of the Plan: budget deficit reduction and a monetary policy focused on maintaining the purchasing power of our money.

Current Economic Situation and Outlook

Let me turn now to economic developments to date and how we see the prospects for the next year.

In the February 1991 budget, we forecast a decline in real output of 1 per cent in 1991, with the recession continuing through the second quarter of the year. We expected moderate growth in the second half of the year but with an unemployment rate still about 10 per cent by year end.

Data indicate that the recession was a little deeper than expected but that the recovery began somewhat earlier than expected. Economic growth in the second quarter was surprisingly strong -- real GDP grew at a 4.9-per-cent annual rate, led by consumption and housing. It is clear that some of the growth we expected in the third quarter actually occurred in the second. For this reason, and because of continuing weakness in the U.S. economy, I expect third quarter growth to be positive but very modest.

The fourth quarter should show a strengthening in growth to the 2-3-per-cent range, reflecting October housing starts growing to over 200,000 units, reasonably firm employment growth in October and the impact of lower interest rates on consumption and inventory rebuilding. Overall, economic growth for 1991 will be in line with the budget projection. However, the unemployment rate in late 1991 and into 1992 will be somewhat higher than we anticipated.

Weak growth in the United States, our major trading partner, has been a factor restraining the pace of recovery in Canada. While it is generally expected that growth in the United States will pick up through 1992, weak corporate and personal balance sheets and structural difficulties in the financial sector will continue to slow the pace of

recovery. This makes it all the more important to continue to strengthen the Canadian economy from within.

A second factor restraining the pace of recovery in Canada is weak personal and corporate confidence. There are a number of reasons for this.

- Consumers and businesses are carrying a heavy debt load, reflecting the rapid growth in borrowing in the late 1980s, and it will take time for better balance to be restored.

- Business, as well, is experiencing a strong squeeze on profit margins as the result of competitive pressures from abroad, high and rapidly rising unit labour costs at home and a strengthening Canadian dollar. Declining inflation, lower interest costs, lower wage increases and greater productivity will improve profit margins, but again this will take time.

- Finally, Canadian industry is undergoing substantial restructuring to meet the challenges of increased globalization; while this will pay substantial medium-term benefits in terms of increased productivity, high real wages and improved market share and profit margins, the adjustment process is not without short-term costs.

Confidence cannot be strengthened by illusory, quick-fix schemes. It requires consistent adherence to a credible medium-term policy framework. The Government of Canada is following such a plan, and the benefits are beginning to be realized, particularly in terms of lower inflation and interest rates for home buyers, for consumers, for businesses. These lower interest rates will directly improve personal and corporate balance sheets, and in the process increase confidence.

It is instructive to look carefully at recent inflation developments in Canada, and the response of financial markets.

Inflation, as measured by the consumer price index, was 4.4 per cent in October, down from an average of 6.4 per cent in the first quarter of this year. But based on month-to-month changes in the CPI since January, the annualized inflation rate for this year has been 1.4 per cent. This represents the best inflation performance since the early 1970s. In short, inflation is well on track to meet our 1992 inflation target of 3 per cent.

Wage pressures have also eased, and further progress is expected. Wage restraint programs introduced by the federal and provincial governments have helped bring public sector wage settlements down from an average of 6.4 per cent in the first quarter of this year to less than 3 per cent in the third quarter. Private sector settlements have declined steadily from an average of 6.5 per cent a year ago to 4.2 per cent in the third quarter. Unit labour costs, the broadest measure of cost pressures, will likely be about 4 per cent in the third quarter as well, a sharp decline from the 5-1/2 to 7-per-cent range experienced since 1988.

This lower inflation has enabled interest rates to continue falling. Short-term interest rates have come down over 625 basis points from their peak in May 1990 and, with the exception of a short period in 1987, are at their lowest levels since the late 1970s. The interest rate on a one-year conventional mortgage is now 8 3/4 per cent at some financial institutions, compared to a peak of 14.25 per cent only last year. The prime corporate lending rate is now at its lowest level since 1978.

Interest rate declines of this magnitude have an enormous impact on the carrying costs of financing a new home and the purchase of consumer durables, and on financing business inventory. For example, this reduction translates into a decline in monthly

payments on a $75,000 mortgage of $285, or 32 per cent. Similarly, the cost of carrying a small business loan of $200,000 is almost $750 a month less, a 22-per-cent saving.

We can be encouraged by the positive developments in the economic picture. For example, the benefits of lower interest rates have translated into an increase of 101,000 jobs since February. But many difficulties and problems still confront us.

To address these difficulties, we must continue the policy course we have set to put Canada on the road to a strong and durable economic recovery. In the February 1991 budget, we forecast growth of 3.5 per cent for 1992 with the unemployment rate averaging just under 10 per cent. Major international agencies as well as Canadian forecast analysts still share this view.

- The OECD predicts the Canadian economy will grow by 3.5 per cent next year;

- The IMF is forecasting 3.8-per-cent growth, the strongest among the G-7 countries.

- An October survey of 14 private sector Canadian forecasters indicated a consensus view of 3.5-per-cent growth for 1992 with an unemployment range averaging just under 10 per cent.

Recent declines in interest rates, and the prospects for further declines as inflation and inflation expectations continue to moderate, will be important factors in producing a climate for moderate, domestic-led growth in Canada next year.

Fiscal Record

I am pleased that, despite the recession, the government met its fiscal targets for 1990-91. The deficit for last fiscal year, at $30.6 billion, almost exactly met our budget forecast of $30.5 billion.

In this regard I want to underline an important point -- this government works to achieve its forecasts. In the past we have taken management initiatives because they were necessary to keep us on track to meet our deficit target. We will take actions again, when they are required, to stick to our fiscal targets. That is what responsible management is all about -- setting clear goals and sticking with a plan that achieves those goals. And this is what builds confidence.

As a share of the economy, the federal deficit has now been virtually cut in half since the government came to office -- from 8.7 per cent of GDP in 1984-85 to 4.6 per cent of GDP last year.

This progress has resulted in large part from the government's restraint of program spending. Last year the growth of program spending was held to only 3.4 per cent, well below the rate of inflation. Over the past six years, we have held the growth of program spending to an average annual increase of 3.6 per cent, also below the rate of inflation.

As a proportion of the economy, program spending has declined from 19.6 per cent of GDP in 1984-85 to 16.0 per cent last year. This is the lowest level in two decades.

The proposed Spending Control Act will ensure that the government maintains disciplined control of program spending. At this time I want to thank the Commons Finance Committee in advance for its review of the draft spending control legislation. I

am looking forward to examining its recommendations. Our aim is to introduce revised legislation in the House before Christmas.

As a result of tight spending discipline, budgetary revenues in 1990-91 exceeded spending on programs by almost $12 billion. This operating surplus compares with a $16-billion operating deficit in 1984-85, a $28-billion turnaround in six years.

However, even with this significant turnaround in the operating budget, we are still fighting to stem the effect of compounding interest on the debt we inherited in 1984. All of the $183 billion in debt that has accumulated since 1984-85 is due to compound interest on the $206 billion of debt we inherited. Continued discipline of program spending will be essential to bring this problem under control.

This commitment to our fiscal targets, despite tough economic circumstances, is not going unnoticed internationally. Compared to the U.S., for example, our financial requirements as a percentage of GDP are now significantly lower and, in particular, our deficit is continuing to come down while theirs is rising. In 1984-85 Canada's financial requirements were 6.7 per cent of GDP compared to a U.S. deficit of 6.3 per cent of GDP (FY 1983). For 1990-91, the fiscal year just ended, our financial requirements were 3.7 per cent of GDP while the U.S. deficit was 5.0 per cent of GDP. And for the current fiscal year, the U.S. deficit is expected to rise to 5.8 per cent while the Canadian situation will be largely unchanged.

Fiscal Outlook

When we set out our fiscal forecast in the February budget, we anticipated an increase in the deficit in the first six months of this fiscal year. This has been the case. In the first half of 1991-92, the deficit is $7.4 billion higher than it was in the same period

last year. This increase reflects both the transitional costs associated with the introduction of the GST and the impact of the recession on revenues and expenditures. Income tax revenues, particularly corporate tax revenues, have been weaker than expected, reflecting the extent of the recession and the squeeze on corporate profits.

I expect the deficit to improve over the rest of the fiscal year as the recovery takes hold together with the end of the transitional costs related to the GST, the effects of lower interest rates on public debt charges, and the impact of the fiscal measures announced in the February budget. As well, we will continue to explore ways to achieve internal economies in the management of government operations. Together, these actions should allow us to be generally in line with our budgetary deficit target of $30.5 billion for 1991-92.

However, two specific pressures have developed that require special attention.

- First, there has been a strong growth in unemployment insurance benefits. Over the first nine months of 1991, benefits have increased by 38 per cent from a year earlier to a total of $13.6 billion. This has generated serious, ongoing deficits in the unemployment insurance account.

- Second, Canadian grain farmers have had their livelihood threatened by an unfair and damaging subsidy war between the United States and the European Community. The government has responded to the emergency needs of farmers with a commitment of an additional $800 million in financial assistance over two years. My colleague, the Minister of Agriculture, will be announcing later today the details of how this money will flow into the hands of Canadian farmers.

Action to Manage Specific Fiscal Pressures

To ensure we continue to make fiscal progress while maintaining our ability to help those in need, the government is taking two key measures:

- As my colleague, the Minister for Employment and Immigration, has announced, the unemployment insurance contribution rate will be increased on January 1, 1992;
- The grain support package for farmers will be financed through a combination of expenditure reallocations and revenue measures.

Dealing with the UI Account Deficit

Earlier this week the Minister of Employment and Immigration announced the government's decision to increase unemployment insurance premiums. At that time, the Minister underlined the importance of maintaining the financial health of the account.

Despite the premium increase last July, the recession has had a heavy impact on the account. It is heading for a large deficit in 1992, and without appropriate action, the cumulative deficit in the UI account would rise to $6.3 billion by 1993.

If we were to allow the account to incur large deficits, we would be exposing it to the same destructive debt dynamics that have plagued our overall budget situation. Indeed, because the government finances any shortfall in the account, a significant UI account deficit in 1992 would severely harm the overall fiscal situation and could undermine the economic recovery. We are not prepared to let this happen. It has therefore been necessary to increase premium rates.

At the same time, the government is sensitive to the circumstances of both employers and employees. We recognize the need to minimize the cost increase to both that would result from raising premium rates.

The $3.00 rate we have determined for 1992 strikes a balance between preserving the financial integrity of the UI Account, containing the impact of deficits in the Account on the overall fiscal position and minimizing the cost increase to employers and employees.

A premium rate of $2.80 would have resulted in an annual deficit in the UI Account of $2.6 billion in 1992 and this would have had a direct impact on the fiscal deficit in 1991-92 and 1992-93. Increasing the rate to $3.20 would have resulted in an annual balance in 1992 and hence prevented the account from going further into a cumulative deficit in 1992. But a rate of $3.20 would represent too large a cost increase to employers and employees.

In effect, the rate of $3.00 "splits the difference" between, on the one hand, leaving the premium rate unchanged and incurring unacceptable deficits in the Account and, on the other, increasing the rate sufficiently to hold the line on further debt build-up but sharply raising costs in the economy.

However, even at a rate of $3.00, the budgetary deficit in both 1991-92 and 1992-93 will absorb a portion of the higher UI deficit, and this will have to be financed through savings from lower interest rates and internal economies. This, I believe, is a fair way of dealing with a very serious problem.

Financing the Farm Support Package

I now want to turn to the support package for Canadian farmers. When the government announced that an additional $800 million in direct support would be provided to farmers, we made it clear that we would do so in a way which fully protects the government's fiscal position.

Since the announcement we have examined a range of options. In reviewing these options we have sought to balance the goals of efficient management and overall fairness. Today I want to indicate to this Committee and to Canadians the specific actions that will finance the support package.

- First, most of the savings from funds originally budgeted for Canada's participation in the Gulf conflict but not required, will be reallocated to the farm support package. This action will provide funds of $400 million in 1991-92.

- Second, the government will take steps to accelerate the collection of outstanding taxes. The vast majority of Canadians who are in a position to pay their income taxes do so in full and on time. It is unfair that some do not. The Minister of National Revenue will be providing details about increased efforts to collect outstanding accounts. In addition, corporations liable for the Large Corporations Tax in any particular year which object to or appeal any tax assessment, will be required to remit 50 per cent of the amount in dispute in respect of that year, pending a resolution of their objections or appeals. Over the last eight years, the amounts in dispute have grown from $300 million to $2.6 billion, with the bulk attributable to large corporations. This measure will ensure that the growth in amounts of unpaid corporate tax will be curtailed. As a

transitional measure, large corporations which have made objections or appeals before 1992 will be given a two-year period over which to remit 50 per cent of taxes in dispute. I shall be announcing shortly details regarding this measure. These measures will generate $400 million in additional revenues in 1992-93.

Together, these actions will secure the additional $800 million for agriculture support without impairing our effort to achieve our current fiscal targets.

Conclusion

In conclusion, let me underline that our Plan for Economic Recovery set out last February is achieving the goals and objectives necessary to put the economy on a sound footing. We are restoring the fundamentally positive conditions that Canada needs for sustained growth and job creation in the months and years ahead.

I know that the patience of many Canadians has been severely tested by the long, difficult effort that has been required to deal with Canada's fiscal and economic challenges. We should not lose sight of the ultimate payoff for this effort that will benefit all Canadians -- the dividends of low inflation, low interest rates and higher real incomes that derive from greater competitiveness and productivity.

But to meet the challenges we will require not just continued patience and perseverance, but a greater effort by all Canadians to work together to solve our common problems.

This reality is reflected in the national consultation process launched by the government last month to address the need for a broadly-based effort to strengthen Canada's competitive position in a tough world marketplace. In the same spirit, as part of the

government's unity initiative, we have put forward for public discussion proposals designed to strengthen the Canadian economic union and the vital contribution it makes to Canada's prosperity and its unity.

Beginning next week, I will be meeting with a wide range of interest groups in a series of consultations across Canada.

These meetings are designed to encourage an exchange of views not only between private sector groups and the government, but among the groups as well. The agenda will focus on the basic fiscal and economic issues that I have discussed today -- dealing with the deficit and the debt, inflation and interest rates and the need for all governments and all Canadians to work more effectively together.

The federal government will continue to do its part by sticking to the course set out in our Plan for Economic Recovery. Sticking to our game plan will help build the confidence needed to give the recovery momentum.

With the co-operation and determination of Canadians in all parts of the country, I am confident we will soon reap the benefits of the future growth and prosperity we all seek.